

***United States Court of Appeals
for the Second Circuit***



**PETITIONER'S
REPLY BRIEF**

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77-4146

United States Court of Appeals
FOR THE SECOND CIRCUIT

LLOYD CARR & CO., LLOYD CARR FINANCIAL CO., JAMES A CARR AND
CHARLES P. LEMIEUX III,

Petitioners,

against

COMMODITY FUTURES TRADING COMMISSION,

Respondent.

Petition for Review of Order of the
Commodity Futures Trading Commission

PETITIONERS' REPLY BRIEF

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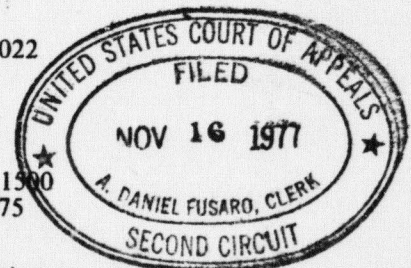


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COMMODITY FUTURES TRADING COMMISSION,

Respondent.

PETITIONERS' REPLY BRIEF

Preliminary Statement

This reply brief is submitted on behalf of the Petitioners in the above-captioned action in response to the brief of Respondent Commodity Futures Trading Commission ("Commission") dated November 10, 1977, and in support of Petitioners' petition for review of the Commission's final order ("Order") dated August 1, 1977 (CFTC Docket No. 77-6) denying Petitioners a Futures Commission Merchant ("FCM") license and imposing other sanctions.

In Petitioners' main brief ("Pet. M. Br."), Petitioners demonstrated that the Commission's Order should be

set aside and that Lloyd Carr should be granted an FCM license because:

(i) the summary termination of the Commission's hearing, before Petitioners could present fully their case, deprived them of due process of law;

(ii) Petitioners met the Commission's FCM licensing standards on January 17, 1977, the day they (and other options traders) were first required to be so licensed, and properly continued to do business thereafter;

(iii) the Commission's finding that Petitioners had exhibited "callous disregard for the law" was wholly unsupported; and

(iv) the sanctions imposed by the Commission -- which effectively would put Petitioners out of business -- were so unduly harsh as to be abusive where, as here, the Commission expressly found that Petitioners had not engaged in any fraudulent or manipulative conduct, and had not breached their fiduciary responsibilities or adversely affected trading on any commodity contract market.

The Commission's brief is unresponsive to these points.

ARGUMENT

I

THE COMMISSION'S BRIEF DOES NOT ANSWER PETITIONERS' CLAIM OF LACK OF DUE PROCESS

The Commission's brief gives due process a back seat by relegating it to a few pages at the end of the brief.

The Commission does not and cannot dispute that: "The hearing was terminated before Petitioners had completed their case." (Opinion at 6 n.7; A-130*). Nor does the Commission seriously challenge the applicability of fundamental principles of due process to administrative hearings. Indeed, the Commission completely ignores Petitioners due process argument and the legal authorities cited in Petitioners' Main Brief at 31 through 38.

When these principles are viewed in light of the facts and the law, the conduct of the Administrative Law Judge ("ALJ") and of the Commission cannot be justified. Accordingly, the Commission's Order must be reversed.

During the hearing on Monday morning, March 21, 1977 at approximately 10:25 a.m., the Petitioners were told for the first time that the Commission was prepared to rest and that Petitioners' case was to proceed. (Tr. 726; A-908) On Tuesday, March 22, 1977, the Petitioners introduced testimony of three witnesses. Their testimony was shortened by adverse rulings as to relevancy but nonetheless continued until 3:00 p.m. (Tr. 817; A-1000) Their three principal and final witnesses were to testify on the next and probably

* Petitioners adopt the same citation form as used in their main brief.

final day of the hearing. Because the three witnesses lived in Boston or New York they were required to fly to Washington. (Tr. 814-815; A-997-998) A storm occurred in the northeast on Tuesday evening, closing Boston and causing very hazardous flying conditions in New York and extensive delays. (Tr. 819; A-1002) The witness from New York took the first flight to Washington on March 23 and arrived at the hearing room at 8:33 a.m. The Boston witness was unable to leave from Boston because the airport was closed and drove to New York in an attempt to reach Washington. (A-110-116)

At 8:32 a.m., two minutes after the time set for the opening of the hearing and one minute before the Petitioners' first witness arrived, the ALJ closed the hearing, preventing Petitioners from introducing evidence or making an offer* of proof. (Tr. 819; A-1002)

Under these circumstances the conduct of the ALJ must be deemed to amount to a denial of due process requir-

* The Commission notes that no proffer was made as to the substance of the excluded testimony. (Comm. Br. 54) The fact is that the closing of the hearing was so peremptory that no opportunity for a proffer was afforded. However, the ALJ can at least fairly be said to have known the importance of the testimony of Mr. Winsten, Petitioners' accountant (who arrived just one minute after the hearing was closed), since he had previously heard Mr. Carr testify that he had directed his accountant to "do whatever is necessary" to "be in compliance" with the Commission's books and record-keeping requirements. (Tr. 274; A-458)

ing a reversal of the Commission's Order which upheld the ALJ's conduct as a mere proper exercise of discretion.

The ALJ terminated the hearing at the point Petitioners were about to begin the relevant, material and critical testimony of James Carr, one of the Petitioners, Irwin Winsten, their accountant, and their office manager, Thomas Labus. The testimony would have been relevant to allegations of violations by Petitioners and was essential to the Commission for the proper exercise of its decision making process. By excluding this testimony, there is no foundation for the Commission's decision to deny registration to Petitioners and to justify its remedial action.

Instead of dealing with the factual and legal claims of denial of due process, as outlined above, the Commission contends that Petitioners doing business after January 17, 1977 alone justifies the imposition of its harshest sanction -- denial of a license -- regardless of whether or not Lloyd Carr was fit to be registered on that date. (Comm. Br. 54-55) As a result the Commission disingenuously claims that its only choice was to grant or deny Petitioners a license, and that to have done other than deny the license would have been "to have registered a firm demonstrably indifferent to legal requirements." (Comm. Br. 46)

Surely, the Commission cannot gainsay the value of evidence it has not even heard -- yet this is precisely the thrust of its argument to this Court.* It is fundamentally unfair to judge Petitioners' conduct on the basis of a record that tells only a fraction of the story. We submit that such a record is, in fact, no record at all.** The Commission attempts, in the waning pages of its brief, to lay the blame for the premature termination of the hearing at the feet of Petitioners' then counsel. (Comm. Br. 56-61) This suggestion -- and the claim that "petitioners have no basis to complain that their attorney succeeded in provoking decisive action by the ALJ" (Comm. Br. 56) -- is as absurd as it is distasteful. Petitioners' witness arrived just one minute after the summary termina-

* It is interesting to note that the Commission's Brief on at least 14 different occasions urges this Court to take cognizance of their argument that "the great weight of authority on the record"; or "the conclusive findings of the ALJ" or "the clear and convincing record" and the like supports the conclusion urged. The Commission engages in advocacy by repetition. The difficulty is that the one sided transcribed proceedings are not, of their very nature either clear and convincing or conclusive of any findings.

** As the Supreme Court stated in Morgan v. United States, 304 U.S. 1 (1938), cited in Pet. M. Br. at 37-38:

"As the hearing was fatally defective, the order of the Secretary was invalid. In this view, we express no opinion upon the merits." Id. at 22.

tion of the hearing. No characterization of Petitioners' former counsel's conduct can justify such precipitous action, nor the consequent denial to Petitioners of the opportunity to present their case.

Petitioners' Main Brief at 31 through 38 clearly demonstrates that the premature termination of the hearing below deprived Petitioners of due process of law, because it precluded them from adducing important evidence favorable to their case. Petitioners contend that if the Commission had heard this evidence,* it would have granted Petitioners a license.

Even if the Commission's contention that Petitioners continuing to do business after January 17, 1977 constituted a violation of the Act, which we deny, this does not obviate the necessity of a due process hearing. The Commission's position in this respect ignores (i) the requirements for a hearing as set forth in Section 8(a)(2)(B) of the Commodity Exchange Act, 7 U.S.C. § 12a (Supp. IV 1974) (see Statutory Appendix at SA 1) and (ii) the legal authorities

* The Commission's counsel clearly stated on the record that the exclusion of such evidence would be reversible error. (Tr. 569; A-752) The Commission in its brief unsuccessfully attempts to explain away this concession (Comm. Br. 55 n.47). We invite the Court's attention to the text of the record, which is dispositive of the point.

(see Pet. M. Br. 31-38). Not only must the Commission afford Petitioner due process, it must also meet a high standard of proof - the clear and convincing evidence standard established by the District of Columbia Circuit in Collins Sec. Corp. v. SEC, CCH Fed. Sec. L. Rep. ¶ 96,122 (D.C. Cir. 1977).*

It should be emphasized that the Commission has available to it a broad panoply of remedies, and it must exercise its discretion on a case-by-case basis, as to which sanction, if any, to impose.** Indeed, this Court only recently admonished the Commission as follows:

"[W]e remind the Commission that the [Commodity Exchange] Act does not compel it to impose across-the-board suspensions automatically whenever any violation is shown, and that it has, and should exercise, discretion in the individual case to

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- * As discussed in Petitioner's Main Brief at 45, this standard was applied in a case involving deprivation of the right of the licensee to pursue a livelihood. Although allegations of fraud were also involved, the court's main emphasis in imposing the higher standard was the harsh sanction.
- ** In the Commission's Brief at p. 44, it asserts that it could only deny or grant registration. This is not so. Indeed, it granted Monex an additional 30 days within which to register and permitted it to operate during that period without a license. See CFTC News Release # 243-77 (Jan. 17, 1977), attached hereto as Addendum 1. The Commission when dealing with Lloyd Carr refuses to exercise discretion and even to acknowledge that discretion exists in the registration process. This further magnifies the discriminatory application of the CFTC's rules and regulations in its evaluation of the Lloyd Carr FCM application.

determine how much of the full statutory remedy it should invoke." Haltmier v. CFTC, 554 F. 2d 556, 564 (2d Cir. 1977).

It is the existence of this discretion that makes a full hearing so important, for without the benefit of a full and complete hearing, the Commission cannot possibly make an informed decision. It is precisely for this reason that it has been held that a full and fair hearing must be provided to one who is the object of agency licensing action -- even when a violation of a statute or rule is clear and uncontested -- so that an adequate opportunity is afforded, "before decisions are crystallized, to make an appeal to [agency] discretion." Blackwell College of Business v. Attorney General, 454 F.2d 928, 932 (D.C. Cir. 1971).*

For the reasons stated above, we submit that the Commission by arbitrarily terminating the proceedings deprived Petitioners of a hearing as required by law.

* The Commission's brief conspicuously fails to even mention this decision and its important holding. Instead, the Commission asserts that the termination of the hearing prior to Petitioners' calling three important witnesses and producing vital evidence, including their books and records, was nothing more than the unreviewable exercise by the ALJ of his "authority to control the progress of the hearing." (Comm. Br. 56)

II

PETITIONERS' COMPLIANCE WITH THE REGISTRATION REQUIREMENTS

Petitioners met the essential requirements for licensing as an FCM on January 17, 1977, and the Commission does not deny this. Specifically, the Commission nowhere disputes that Petitioners had nearly twice the net working capital required for licensing. Nor does the Commission deny that Petitioners met the fitness requirements as of that date.*

Except for challenging the validity of the Commission's regulations,** the Petitioners have made no attempt to evade or avoid the Commission's registration rules and regulations. To the contrary, they have always sought to comply with them. The Commission itself found that Petitioners engaged in no fraud, manipulation or breach of

* The Commission's January 19, 1977 release (42 Fed. Reg. 3,699 (1977)) clearly states that registration was granted to all firms who met the working capital requirements and were otherwise found fit. It is interesting to note that the Commission in its brief (Comm. Br. 26-27) for the first time characterizes Lloyd Carr's alleged violations of the Act, i.e., its continuing to do business after January 17, as amounting to unfitness in contradiction of a Commission witness, Mr. James Cooper, who testified that James Carr had met all the fitness requirements. (Tr. 524; A-707)

** British American Commodity Options Corp. v. Bagley, 552 F.2d 482 (2d Cir. 1977), cert. denied, 46 U.S.L.W. ___ (U.S. Nov. 7, 1977) (No. 77-96).

fiduciary responsibilities (Opinion at 55; A-179), and that their conduct had no adverse effect on any contract market (Opinion at 56; A-180).

Indeed, the Commission "did not question [Petitioners'] fair dealing or training program." (Opinion at 52; A-176) The Commission knew on January 17 that Petitioners were continuing to do business, and the Commission's counsel nonetheless represented to this Court on that date that there would be "no problems" if Petitioners met the registration requirements (Tr. 750; A-933; Pet. M. Br. 48). Petitioners met those requirements and should have been registered.

This Court should exercise its discretion under 5 U.S.C. § 706(1)(1970) to vacate the Commission's order and direct the Commission to issue Lloyd Carr an FCM license.

III

PETITIONERS DID NOT WILFULLY VIOLATE THE ACT

We shall discuss below the following. First, Section 9 of the Administrative Procedure Act, 5 U.S.C. § 558(c)(1970) permits the Petitioners to continue their business pending final determination of its application for a FCM license, second, the Petitioners did not refuse to permit the Commission to conduct an audit, and, third, the Petitioners properly maintained their books and records.

A. Section 9 of the Administrative
Procedure Act

The decision by Petitioners and their associated persons* to continue doing business after January 17, 1977 is relied upon by the Commission as a basis for denying registration. (Opinion at 52; A-175; Comm. Br. 26) The Commission recognizes, however, that if the conditions of Section 9 of the Administrative Procedure Act, 5 U.S.C. § 558(c)(1970) are met, Petitioners continuing to do business could not be deemed a willfull violation of the Act. (Opinion at 23; A-147)

The Supreme Court has enunciated four standards in order for the protections of Section 9 to apply, namely,

- (a) There must be a license outstanding;
- (b) It must cover activities of a continuing nature;
- (c) There must have been filed a timely and sufficient application to continue the existing operation; and
- (d) The application for the new or extended license must not have been finally determined.

* As to associated persons, see the discussion in Petitioner's Main Brief at p. 29 n.2.

Pan-Atlantic Steamship Corp. v. Atlantic Coast Line Ry. Co.,
353 U.S. 436, 439 (1957).

As to (b) above, the Petitioners at all times engaged only in the continuing activity of selling options on commodity futures in the London markets. As to (a) above, prior to January 17, 1977, the Commission generally required a person engaged in the selling of options to have a Commodity Trading Advisor ("CTA") license. Petitioner obtained such a license in November 1976 and that license was outstanding on January 17, 1977. (Tr. 524; A-707)

While the Commission admits in its opinion (Opinion at 26; A-150) and its brief (Comm. Br. 40) that Petitioners had a CTA license outstanding, the Commission contends "[t]hat [the CTA] registration does not purport to license the solicitation and acceptance of orders and funds for the purchase of options." (Id.) Nothing could be further from the truth. The Commission in an interpretive release issued on October 22, 1975 stated: "[g]enerally, persons who are offering commodity options to the public are required to register [as CTAs]." 40 Fed. Reg. 49,360, at 49,361 n.11 (1975).

Further, failure to be registered as a CTA by one who sold commodity options was a basis for Commission injunc-

tive action. CFTC v. British American Commodity Options Corp., 560 F.2d 135 (2d Cir. 1977).

As to (c) above, the Petitioners filed an application to continue the activity of selling options on October 1, 1976. It is undisputed that a completed application including a statement of financial condition was submitted by Petitioners to the Commission on January 17, 1977. (Comm. Br. 19) The record also reflects that at the urging of the Commission only the name on the application was changed from Lloyd Carr Financial to Lloyd Carr & Co.* on January 26, 1977. (Pet. M. Br. 5, 13).

The October 1, 1976 application is alleged by the Commission to have been defective and as such it is urged that it not be considered a continuing application. However, this charge comes too late to be given any credence. Since under the Commission's regulations (17 C.F.R. § 1.13 (1977)) it must return a filing fee when a license is refused and since it did not return Petitioners' fee,** the

* As demonstrated in Petitioners' Main Brief at 5 and 13 this was merely a matter of form and not of substance.

** The Commission does not dispute that the filing fee was not returned to Petitioners and that it was deposited. The cancelled check for the filing fee was introduced in the record of the administrative proceeding. (Dx. 10; A-1064)

application must be considered as pending. Had the Commission determined that the October 1, 1976 application should be denied, its return of the filing fee in accordance with its own rules would have alerted Petitioners to the fact that the Commission no longer considered the application pending.

A failure by the predecessor agency of the Commission to follow its own rules has been held by the Department of Agriculture to be a fatal defect* in the assertion that the protections of Section 9 of the Administrative Procedure Act, 5 U.S.C. § 558(c)(1970) do not apply. In re Petro, 8 Ad. L.2d (P & F) 129 (U.S.D.A. 1957).** See also Economou v. United States Dep't of Agriculture, 494 F.2d 519 (2d Cir. 1974).

In any event, Petitioners resubmitted on January 17, 1977*** an application for an FCM license containing all of the information needed for consideration of their appli-

* Lloyd Carr did not receive a deficiency letter setting forth the alleged defects in its October 1 FCM application until late December or early January when its then counsel obtained a copy for it. (Pet. M. Br. 8)

** A copy of the opinion is attached hereto as Addendum B.

*** It should be noted that there was no specific filing date set forth by statute or regulation of the Commission.

cation and this application supplemented the pending October 1, 1976 application.

As to (d) above, there is no dispute that on January 17, 1977 the application for Petitioners' license had not been finally determined.

Thus, the protections of the Administrative Procedure Act apply to Petitioners' activity of continuing to do business after January 17, 1977 and until final disposition of Petitioners' application. The finding by the Commission on August 1, 1977 that the continuation of doing business after January 17, 1977 by the Petitioners constituted a willful act which alone could serve as a basis for denying registration must fail as a matter of law.

On February 2, 1977, the CFTC filed an administrative Complaint against Lloyd Carr and immediately thereafter brought an action in the U.S. District Court for Massachusetts, Case No. 77-371T, before Judge Tauro seeking the injunctive relief of a cease and desist order. A temporary restraining order, if granted, would have compelled Lloyd Carr to cease and desist its operations, closing its eight branch offices and idling some 500 employees, on the basis of an alleged violation of continuing to do business after January 17th without registration. The court denied the Commission's request for a temporary restraining order on two separate

occasions (February 8, 1977 and August 8, 1977) after hearing arguments by both sides, including the Section 9 defense.

After the Commission entered its August 1, 1977 cease and desist order and its second request for a temporary restraining order was denied, it sought to enforce the Order, which is not self-executing, by once again applying for injunctive relief before Judge Tauro, this time in the form of a preliminary injunction. The court stayed the Commission's motion for a preliminary injunction to summarily terminate the business of Petitioners (September 7, 1977) on the basis that the issues involved before it were substantially similar to those which are here on review and ought not to be decided in a summary fashion.

B. The Petitioners' Did Not Refuse to Permit the Commission to Conduct an Audit

The Commission also makes much ado about Petitioners' alleged failure to permit a "second audit" of their books and records. The Commission's version of the record is simply not accurate.

The record demonstrates that Petitioners did not oppose a second audit, but simply questioned the need for and the participation of Division of Enforcement personnel

in that audit and sought assurances from the Division that customers would not be contacted improperly. (Pet. M. Br. 14-16) This request required nothing more than an affirmation by the Enforcement Division that it would undertake to comply with its own rules concerning the confidentiality of investigations. 17 C.F.R. § 11.3 (1977). When Enforcement refused to agree to comply with its rules against disclosure of nonpublic investigations to Petitioners' customers, the Petitioners refused to grant Enforcement access. The Commission does not deny that this practice by Enforcement had been a problem in the past, and that it had made disclosures of non public investigations involving Petitioners as noted in the ALJ's recommended decision (Rec. Dec. at 23; A-96).

Significantly, the Commission's brief also leaves unanswered the finding of the ALJ that the reason for the second audit was never clearly communicated to Petitioners. The Commission now claims it wanted only to verify that Petitioners were qualified to be registered and that Petitioners' books were in order. Why, then, the need for Division of Enforcement personnel? The request for an enforcement investigation was not part of the normal pattern of pre-registration activity of the Commission. (See Pet. M. Br. 9-16) It is submitted that there was no valid reason, save the possibility of a pre-determined de-

cision by the Commission and especially by Enforcement, to deny registration to Petitioners. See Point V, infra. This inference is supported by the fact, as pointed out in Petitioner's Main Brief at 12, that the Commission's auditor Chan and two supervisory auditors had previously indicated to Petitioners that registration would be granted and that the issuance of the FCM license was imminent. (Tr. 496-497; A-680-681)

Even today we are not presented with a credible reason for the so-called second audit. Certainly the Commission's Brief at 21, which attempts to allege at this late date that the reason was "to determine whether all regulatory criteria for registration had been met," is in direct contradiction to the testimony of Messrs. O'Brien and McCarthy (Tr. 655; A-838) whose responsibility it should have been to register Petitioner.

Had the hearings not been abruptly terminated, Petitioners' books and records would have been presented to the Commission (A-110-116) and its personnel could have made as many audits as they desired.* The tragic consequences of

* Petitioners' new counsel offered in August 1977, to permit the Commission to make a complete audit of all Petitioners' books and records. The Commission accepted this offer, and over a period of seven days, two Commission auditors scoured Petitioners' books. No charge has since been made that the condition of these books was other than impeccable.

this sudden termination of the hearings is set forth in true perspective in the decision submitted by the ALJ where it is stated:

"The truth is that respondents may well have been registered with this Commission had they permitted an audit of their books and records on or about the 25th of January; and this decision would be considerably different in result had respondents permitted an audit of their books and records during or after the hearing." (Rec. Dec. at 29; A-102)(emphasis added)

Accordingly, the characterization of the denial of a second audit as a "willful violation" cannot and should not be permitted to stand as a basis for a denial of registration and for the imposition of other sanctions.

C. The Petitioners Properly Maintained Their Books and Records

The Commission makes much of the condition of Petitioners' books and records at the time of its first audit although the Commission expressly stated this so-called condition was not grounds for denying Petitioners' their FCM license. If in fact the Commission was dissatisfied with Petitioners' books, it should have informed Petitioners of the reasons for its dissatisfaction by sending a "comment" or "deficiency" letter. The Commission's own witnesses admitted that this is the usual practice (Tr. 689; A-782), but in this case the Commission's auditor was

specifically instructed not to send such a letter. (Tr. 407; A-590)

The Commission tries to get around this defect by suggesting that its auditor's comments about Petitioners' books at the time of the first audit should be deemed to constitute "oral" notice. (Comm. Br. 20) Even if such notice were sufficient, which is not conceded, the fact is that Petitioners promptly undertook to prepare their books in a form acceptable to the Commission (Tr. 370-371; A-553-554); they advised the Commission's auditor that they would do so (Tr. 274; A-458); and they were about to introduce their entire books and records into evidence to prove such compliance when the hearing was abruptly terminated.

This Court has held in Economou v. United States Dep't of Agriculture, 494 F.2d 519 (2d Cir. 1974), that an opportunity should be provided to correct books and record-keeping deficiencies before sanctions are imposed.* The

* At the hearing, Petitioners' counsel stated:

"All we are asking is to give us an opportunity to comply. We're doing the best we can, but we're operating in a vacuum. We don't know what they want, and they never told us."

* * *

"Give us the letter. That's all we're asking. And we'll do it." (Tr. 571; A-754).

Commission does not dispute this point; it does not attempt to distinguish Economou, nor does it even mention that decision in its brief. The reason the Commission does not base its determination in this case upon its books and records allegations is that, as a matter of fact and law, it could not; for the Commission to suggest otherwise would have been improper.

IV

THE COMMISSION'S SANCTIONS ARE UNDULY HARSH AND VINDICTIVE

The Commission would have this Court believe that its sanctions in this case are but a "mild prophylactic" (Comm. Br. 46) and that the Petitioners can simply re-apply for a license at some future date. Nonsense!* The Commission's sanctions would effectively put Petitioners out of business, despite the facts that:

- (1) The Commission expressly found that Petitioners had engaged in no fraud, manipulation or breach of their fiduciary responsibilities.
- (2) The Commission further found that Petitioners' activities had no adverse effect on trading in any contract market.

* In fact, the findings of the Commission here, if allowed to stand, could serve as a basis for denying Petitioners registration for the next ten years. See the Commission's July 3, 1975 interpretive release (40 Fed. Reg. 28,125, at 28,126 (1975)), a copy of which is annexed hereto as Addendum C.

(3) Petitioners have met the fitness requirements.

(4) Petitioners have met the financial requirement.

As illustrated below, the Commission's posture here is a study in contradiction. First, it claims, on the one hand, that it can put Petitioners out of business because it must "assure that only those meeting the highest ethical standards will be allowed to engage in the futures and options industry." (Comm. Br. 46) Yet, on the other hand, it states in its Opinion that it "did not question [Petitioners'] fair dealing or training program." (Opinion at 52; A-176) Second, one of the Commission's bases for denying Petitioners' application is the alleged refusal of the Petitioners to allow a second audit, claiming that a second audit was needed to verify the condition of Petitioners' books and records. Yet the Commission fails to impose a sanction because of the manner in which Petitioners maintained their books and records. Third, another basis for the Commission's action is the alleged lack of "registration of many of its sales persons as associated persons" (Opinion at 51; A-175) Yet during the course of the truncated hearing the Commission registered such sales persons. (Tr. 788-791; A-971-972)

While sanctions such as those imposed here may be technically within the arsenal of available remedies, the

Commission has not cited a single decision -- and we are aware of none -- in which suspension, revocation or denial of a license is decreed absent fraud, overreaching, manipulation or the like. As this Court stated in British American Commodity Options Corp. v. Bagley, 552 F.2d 482 (2d Cir. 1977):

"We agree that the laudable intent to protect the public cannot give regulators unbridled freedom to do as they wish." Id. at 491.

The Commission mistakenly relies upon CFTC v. British American Commodity Options Corp., 560 F.2d 135 (2d Cir. 1977), to support its contention that denial of a license here is appropriate. In that case, this Court reversed a district judge's denial of preliminary injunctive relief enjoining an unlicensed commodity options dealer from doing business where, wholly unlike the facts of this case, (i) the Commission charged the dealer with defrauding the public, (ii) the principal of the dealer had previously been the subject of two SEC consent decrees enjoining him from further fraudulent practices -- an express statutory basis for denial of a license by the Commission* -- and (iii) the dealer had failed to comply with existing regula-

* See Section 8(a) of the Commodity Exchange Act, 7 U.S.C. § 12a (Supp. IV 1974). A copy of this section is annexed hereto as part of the Statutory Appendix SA 1.

tions already in effect prior to the time the dealer had commenced doing business. Although this Court stated that a showing of fraud or misconduct was not an essential prerequisite for injunctive relief where a statutory violation had been shown, it by no means held that a firm could be put out of business in every case upon a mere showing of an alleged statutory violation. The Court stated that "there is always some measure of equitable discretion even in statutory injunctive actions" and added that district courts should not become "a rubber stamp and issue an injunction whenever the Commission applies for one." 560 F.2d at 143-144.

The excessively harsh nature of the Commission's sanctions here was apparent even to the ALJ below. After hearing the facts and evaluating the witnesses during the abbreviated hearing, he concluded that, because no charges of fraud or misdealing had been made, "it appeared that the issues in this case could have been settled on terms other than putting [Petitioners'] operation out of business," a result which he found "would cause a great hardship for a number of people."* (Rec. Dec. at 26; A-99)

* The ALJ is not the only person to have recognized the inherent harshness of putting Petitioners out of business under the facts of this case. On three separate occasions, the Commission sought temporary or preliminary injunctive relief from the United States District Court for the District of Massachusetts, and on each occasion such relief was denied. See pp. 16-17 supra.

Indeed, it is clear that he did not base his decision on the facts -- relied on exclusively by the Commission in this Court -- that Petitioners continued to do business after January 17 and allegedly refused to permit a "second audit" of their books and records. Rather, he stated that his Recommended Decision "would be considerably different in result had [Petitioners] permitted an audit of their books and records during or after the hearing." (Rec. Dec. at 29; A-102) In fact, Petitioners did permit such an audit (Tr. 633, 720; A-816, 902), and would have introduced into evidence their entire books and records had the hearing not been preemptorily ended in the midst of their case.

The Commission's sanctions in this case are wholly disproportionate to the purely technical nature of the violations alleged. They should not be permitted to stand.

V

CONDUCT OF THE CFTC PREJUDICIAL
TO LLOYD CARR

When an agency violates its own rules and regulations in such a fashion as has been described above and as is otherwise evident from the record, its decision may not stand. Blackwell, supra; Economou, supra.

An examination of the record and the history of the Commission's actions toward Lloyd Carr reveals that it

never intended to license Lloyd Carr or to give it a fair hearing and that it is and has been for some time* determined to put Lloyd Carr out of business. Thus:

1. After learning that three of its audit staff were prepared to license Lloyd Carr as an FCM and had so indicated to Lloyd Carr (Tr. 153, 496-497, 678-679; A-337, 680-681, 861-862) the Division of Enforcement intervened to prevent its registration by insisting on a special enforcement investigation before registration (Tr. 655; A-838).
2. In February, August and again in September, 1977, the Commission sought in the U.S. District Court for Massachusetts injunctive relief which would have effectively prevented Petitioners from continuing doing business. All three applications were denied. See pp. 16-17 supra.
3. On February 3, 1977, the Commission also instituted the administrative proceeding to determine whether Petitioners' application for registration as an FCM should be granted or denied and for other relief.
4. At the very outset of the Administrative hearing the ALJ stated: "Commissioner Bagley has a great interest in this proceeding." (Tr. 14; A-198).
5. The ALJ, the Commission and its staff demonstrated a pattern of prejudicial conduct in the administrative proceeding in that they:
 - (a) shortened the time within which petitioners could normally object to the staff's application for an expedited proceeding. (Compare 17 C.F.R. §10.26(b) (1977) with A-19-20);

* This attitude became evident after the Petitioners challenged the CFTC's regulatory program. See British American Commodity Options Corp. v. Bagley, 552 F.2d 482 (2d Cir. 1977), cert. denied, 46 U.S.L.W. ____ (U.S. Nov. 7, 1977) (No. 77-96).

- (b) ordered an expedited hearing without a demonstration that Petitioners would not be prejudiced (17 C.F.R. § 10.3 (1977));
 - (c) limited the time for discovery so as to effectively foreclose any discovery (A-31-35);
 - (d) set the time and place for the hearing over the objection of Petitioners without regard to the convenience of the Petitioners, their witnesses and their counsel, all in violation of 17 C.F.R. § 10.61 (1977);
 - (e) transferred the location of the hearing from Boston to Washington without notice and over Petitioners' objection (Tr. 270,702, 726, 737; A-454, 885, 908, 920);
 - (f) wrongfully excluded evidence as to the proper and professional conduct of Petitioners' business (Tr. 813-814, A-996-887);
 - (g) summarily and unjustifiably terminated the hearing at 8:32 a.m., two minutes after the hour designated for commencement of the hearing because of the absence of witnesses for Petitioner;
 - (h) refused to reopen the hearing at 8:33 a.m. in spite of (i) the arrival of a witness for Petitioners who had been unavoidably delayed by a snow storm and (ii) the expectation of the arrival of two other critical witnesses for Petitioners;
 - (i) used a defective and partial record as a basis for an order denying registration to Petitioners and imposing other remedial sanctions.
 - (j) Notwithstanding the so-called necessity for an expedited hearing the Commission took more than four months to render its decision.
5. While this appeal has been pending, the Commission and its personnel began to engage in conduct

which was designed to force Petitioners out of business notwithstanding the denial of injunctive relief sought.*

- (a) The Commission issued a Press Release on August 16, 1977 stating it would revoke the licenses of associated persons working for Petitioners but on the next day rescinded it since it appeared to be a pronouncement of a new policy in violation of the Administrative Procedure Act requirements for publication prior to announcement of such policy changes. Further, no such action has even been taken.
- (b) The Commission's intervention in the actions initiated by the Attorney General of Michigan (see Comm. Br. 48 n.40) in support of the Attorney General and against Lloyd Carr represents a significant departure from its previously announced position. This position is contrary to the position taken by the Commission in an amicus brief submitted by the Commission on behalf of a dealer in opposition to the assumption of jurisdiction by the state of Arkansas. International Trading Ltd. v. Bell, CCH Comm. Fut. L. Rep. ¶ 20,495 (Ark. Oct. 3, 1977). In Arkansas, the Commission took the position that there is exclusive Federal jurisdiction relating to the regulation of commodities and that the area is

* On November 11, 1977 petitioners filed a complaint in the U.S. District Court for the District of Columbia (CA 77-) seeking a temporary and permanent injunction requiring individual defendant employees and officials of the Commission to cease willful, wrongful and deliberate interference with the contractual rights of the Petitioners and requiring them to comply with the CFTC Act and rules and regulations promulgated thereunder and compensatory and punitive damages. The Complaint also seeks a mandamus against the Commission and its employees in their official capacities.

pre-empted by Federal regulation.* This position was sustained by the Supreme Court of Arkansas. Id.

- (c) On October 12, 1977 the Commission initiated an administrative proceeding seeking the same relief which the Commission unsuccessfully had sought in the U.S. District Court for the District of Massachusetts, i.e., an order requiring the Petitioners to cease and desist doing business permanently. The denial of this relief has been appealed by the Commission to the First Circuit.
- (d) Defendant Levie, as staff attorney for the CFTC responsible for this matter, contacted the account officer of the Union Trust Company and was responsible for having that bank terminate an account of Petitioners' which had \$140,000 in deposits. As the ALJ stated: "It is a rare bank that turns that kind of money out into the cold."
(Rec. Dec. 23; A-96)

- 6. Finally, there appears to be unanswered even today the question of why Monex Trading Corp., a firm of commodity option dealers, was permitted to continue doing business with the Commission's interpretive blessing without registration.** Also unanswered is the ques-

* In note 40 of its Brief the Commission suggests that the State of Michigan has raised questions concerning Petitioners' sales practices. While the State of Michigan obtained a temporary restraining order based upon affidavits only and without opportunity for testimony or cross-examination, a hearing is scheduled for November 22, 1977 on the issue of a preliminary injunction at which time Petitioners will seek to vacate the order and dismiss the complaint. In any event the actions of the State of Michigan, and the CFTC's belated intervention therein, cannot be relevant to this Court's judgment since the Commission's own interpretations so provide. 40 Fed. Reg. 28,126 (1975).

** CFTC News Release #243-77 (Jan. 17, 1977).

tion of why Bristol Options and International Commodity Options were permitted to continue through October 1, 1977 and may well be continuing at this time to engage in the sale of commodity options without registration and with the Commission's apparent blessing. The Commission pointedly omits to deal with these questions in its brief despite petitioners having raised them at page 55 of its main brief.

CONCLUSION

For all of the above reasons, the order of the Commission should be vacated and the Commission should be directed to issue a Futures Commission Merchant license to Petitioners in accordance with 5 U.S.C. § 706(1) (1970) and Petitioners should be granted costs and appropriate attorneys fees.

Dated: New York, New York
November 16, 1977

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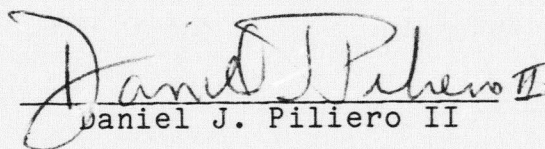
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CERTIFICATE OF SERVICE

I certify that I have this day served upon the Respondent herein two copies of Petitioners' Reply Brief by mailing same, certified mail, return receipt requested, to Respondent Commodity Futures Trading Commission, Washington, D.C. 20581

Dated: New York, New York
November 16, 1977


Daniel J. Piliero II

STATUTORY APPENDIX

5 U.S.C § 558(c) (1970)

(c) When application is made for a license required by law, the agency, with due regard for the rights and privileges of all the interested parties or adversely affected persons and within a reasonable time, shall set and complete proceedings required to be conducted in accordance with sections 556 and 557 of this title or other proceedings required by law and shall make its decision. Except in cases of willfulness or those in which public health, interest, or safety requires otherwise, the withdrawal, suspension, revocation, or annulment of a license is lawful only if, before the institution of agency proceedings therefor, the licensee has been given—

(1) notice by the agency in writing of the facts or conduct which may warrant the action; and

(2) opportunity to demonstrate or achieve compliance with all lawful requirements.

When the licensee has made timely and sufficient application for a renewal or a new license in accordance with agency rules, a license with reference to an activity of a continuing nature does not expire until the application has been finally determined by the agency.

7 U.S.C. § 12a (1970)

§ 12a. Registration of commission merchants and brokers; fees; rules and regulations; publication of harmful acts; disapproval of by-laws, etc.

The Commission is authorized—

(1) to register futures commission merchants and persons associated therewith as described in section 6k of this title, commodity trading advisors, commodity pool operators, and floor brokers upon application in accordance with rules and regulations and in form and manner to be prescribed by the Commission; and

(2) to refuse to register any person—

(A) if the prior registration of such person has been suspended (and the period of such suspension shall not have expired) or has been revoked;

(B) if it is found, after opportunity for hearing, that the applicant is unfit to engage in the business for which the application for registration is made, (i) because such applicant, or, if the applicant is a partnership, any general partner, or, if the applicant is a corporation, any officer or holder of more than 10 per centum of the stock, at any time engaged in any practice of the character prohibited by this chapter or was convicted of a felony in any State or Federal court, or was debarred by any agency of the United States from contracting with the United States, or the applicant willfully made any material false or misleading statement in his application or willfully omitted to state any material fact in connection with the application, or (ii) for other good cause shown; or

(C) in the case of an applicant for registration as futures commission merchant, if it is found after opportunity for hearing that the applicant has not established that he meets the minimum financial requirements under section 6f of this title: *Provided*, That pending final determination under clause (B) or (C), registration shall not be granted: *And provided further*, That the applicant may appeal from a refusal of registration under clause (B) or (C) in the manner provided in section 9 of this title; and

(3) in accordance with the procedure provided for in section 9 of this title, to suspend or revoke the registration of any person registered under this chapter if cause exists under paragraph (2)(B) or (C) of this section which would warrant a refusal of registration of such person, and to suspend or revoke the registration of any futures commission merchant who shall knowingly accept any order for the purchase or sale of any commodity for future delivery on or subject to the rules of any contract market from any person if such person has been denied trading privileges on any contract market by order of the Commission under the provisions of section 9 of this title and the period of denial specified in such order shall not have expired; and

(4) to fix and establish from time to time reasonable fees and charges for registrations and renewals thereof; and

(5) to make and promulgate such rules and regulations as, in the judgment of the Commission, are reasonably necessary to effectuate any of the provisions or to accomplish any of the purposes of this chapter;

(6) to communicate to the proper committee or officer of any contract market and to publish, notwithstanding the provisions of section 12 of this title, the full facts concerning any transaction or market operation, including the names of parties thereto, which in the judgment of the Commission disrupts or tends to disrupt any market or is otherwise harmful or against the best interests of producers and consumers; and

(7) to alter or supplement the rules of a contract market insofar as necessary or appropriate by rule or regulation or by order, if after making the appropriate request in writing to a contract market that such contract market effect on its own behalf specified changes in its rules and practices, and after appropriate notice and opportunity for hearing, the Commission determines that such contract market has not made the changes so required, and that such changes are necessary or appropriate for the protection of persons producing, handling, processing, or consuming any commodity traded for future delivery on such contract market, or the product or byproduct thereof, or for the protection of traders or to insure fair dealing in commodities traded for future delivery on such contract market. Such rules, regulations, or orders may specify changes with respect to such matters as:

(A) terms or conditions in contracts of sale to be executed on or subject to the rules of such contract market;

(B) the form or manner of execution of purchases and sales for future delivery;

(C) other trading requirements, excepting the setting of levels of margin;

(D) safeguards with respect to the financial responsibility of members;

(E) the manner, method, and place of soliciting business, including the content of such solicitations; and

(F) the form and manner of handling, recording, and accounting for customers' orders, transactions, and accounts; and

(8) to make and promulgate such rules and regulations with respect to those persons registered under this chapter, who are not members of a contract market, as in the judgment of the Commission are reasonably necessary to protect the public interest and promote just and equitable principles of trade, including but not limited to the manner, method, and place of soliciting business, including the content of such solicitation; and

(9) to direct the contract market whenever it has reason to believe that an emergency exists, to take such action as, in the Commission's judgment, is necessary to maintain or restore orderly trading in, or liquidation of, any futures contract. The term "emergency" as used herein shall mean, in addition to threatened or actual market manipulations and corners, any act of the United States or a foreign government affecting a commodity or any other major market disturbance which prevents the market from accurately reflecting the forces of supply and demand for such commodity: *Provided*, That nothing herein shall be deemed to limit the meaning or interpretation given by a contract market to the terms "market emergency", "emergency," or equivalent language in its own bylaws, rules, regulations, or resolutions.

17 CFR § 1.13 (1970):

§ 1.13 Deposit of registration fee; fee not subject to refund after registration.

Upon receipt of an application for registration (or renewal thereof) the Commission will, if the application be approved, notify the registrant that he has been registered under the Act. If registration is refused, the fee shall be returned to the applicant, but if the applicant is registered, the fee will not be subject to refund.

17 CFR § 1.17 (1977):

§ 1.17 Minimum financial requirements.

(a) Except as provided in paragraphs (b) (1) and (b) (2) of this section, no person applying for registration as a futures commission merchant shall be so registered unless he has adjusted working capital equal to or in excess of whichever of the following is greater: (1) \$10,000 or (2) the sum of the safety factors hereinafter prescribed in this section with respect to both proprietary accounts and customers' accounts plus 5 percent of the applicant's aggregate indebtedness; and each person registered as a futures commission merchant shall at all times continue to meet such financial requirements.

(b) (1) Except as provided in paragraph (b) (2) of this section, no person registered as a futures commission merchant shall engage in commodity option transactions referred to in Part 32 of this chapter unless he has adjusted working capital equal to or in excess of whichever of the following is greater: (i) \$50,000 or (ii) the sum of the safety factors hereinafter prescribed in this section with respect to both proprietary accounts and customers' accounts plus 5 percent of the applicant's aggregate indebtedness; and each such person registered as a futures commission merchant shall at all times continue to meet such financial requirements.

(2) The requirements of paragraphs (a) and (b) (1) of this section shall not apply if the applicant for registration or registrant is a member of a contract market and conforms to minimum financial standards and related reporting requirements set by such contract market in its bylaws, rules, regulations or resolutions approved by the Commission: *Provided, however,* That a futures commission merchant who engages in option

transactions referred to in Part 32 of this chapter shall at all times maintain a minimum capital of \$50,000 computed in accordance with the applicable bylaws, rules, regulations or resolutions of such contract market which have been approved by the Commission.

(c) Definitions: For the purposes of this section:

(1) The term "working capital" means the amount by which current assets exceed current liabilities.

(2) The term "current assets" means cash and other assets or resources commonly identified as those which are reasonably expected to be realized in cash or sold during the next twelve months in the normal course of operation of the principal business of the applicant or registrant, and which are available for and intended for payment of current liabilities. The term "current assets" excludes:

(i) Any unsecured customer's commodity futures account containing a ledger balance and open trades, the combination of which liquidates to a deficit or containing a debit ledger balance only and which account has been in such condition for more than 30 consecutive days;

(ii) [Reserved]

(iii) Any unsecured commodity futures account, which is a "proprietary account" as defined in § 1.3(y) and which account contains a ledger balance and open trades, the combination of which liquidates to a deficit or contains a debit ledger balance only;

(iv) [Reserved]

(v) Any unsecured loan or advance on the part of applicant or registrant to any person whose account is classifiable as a proprietary account under these regulations;

(vi) Crop loan (loans made to farmers for the purpose of financing their crops or farm operations) which are not (A) due and collectable within nine months after the respective dates of the making of such loans, and (B) evidenced by legally enforceable written instruments in the possession of the applicant or registrant;

(vii) All other unsecured receivables that are not due within six months from the respective dates of their inception;

(viii) All unsecured receivables that are not collectable within six months from the respective dates of their inception;

(ix) All past due unsecured receivables;

(x) Exchange memberships, clearing house stocks and guaranty funds;

(xi) Unrealized commissions on open futures contracts;

(xii) Cash and claims to cash which are restricted as to withdrawal;

(xiii) Fixed assets, such as land, building, furniture and fixtures, improvements to real property;

(xiv) Prepaid expenses and deferred charges;

(xv) Securities without a ready market; and

(xvi) Everything excluded from such term in accord with generally accepted accounting principles.

(3) A loan or advance or any other form of receivable shall not be considered secured unless the following conditions exist:

(i) The receivable is secured by collateral which can be readily converted into cash equal to or in excess of that part of the receivable which is shown in the creditor's records as secured; and

(ii) The collateral is in the possession and control of the creditor; or

(iii) The creditor has a legally enforceable, written security agreement, signed by the debtor, and has a perfected security interest in the collateral within the meaning of the laws of the state in which the collateral is located.

(4) The term "current liabilities" means obligations that are due and payable or will become due and payable in the next 12 months, or the liquidation of which is reasonably expected to require the use of existing resources classifiable as current assets or the creation of other current liabilities. It would include any long-term loan which is not evidenced by a legally enforceable written instrument and any long-term liability that can be accelerated at the creditor's option to a term of a year or less. For the purpose of computing "working capital" within the meaning of this section, the following amounts may be excluded from current liabilities:

(i) The amount of indebtedness subordinated to the claims of all general creditors of the applicant or registrant pursuant to a satisfactory subordination agreement, as hereinafter defined; and

(ii) The amount of money, securities and property due to commodity customers, which is held in segregated accounts in compliance with the requirements of section 4d(2) of the Act and the regulations thereunder: *Provided, however,* That such exclusion may be taken only if such money, securities and property held in segregated accounts has also been excluded from current assets in computing working capital.

(5) The term "satisfactory subordination agreement" means an agreement which satisfies all the following conditions:

(i) It is a written agreement duly executed by the applicant or registrant and the lender or creditor, which agreement is legally binding and enforceable in accordance with its terms upon the lender or creditor and his creditors, heirs, executors, administrators, assigns and successors in interest;

(ii) It effectively subordinates any right of the lender or creditor to demand or receive payment or return of the cash, securities or property loaned or otherwise owed, to the claims of all present and future creditors of the registrant or applicant: *Provided, however,* With the consent of the borrower, prior to the maturity of the agreement, the lender

may substitute cash or other assets, with a ready market at an equal or greater value, for the assets initially loaned, if the agreement provides for such substitution and is modified so that the substitute cash or assets are subordinated in accordance with this regulation;

(iii) The agreement shall be in effect for a period of not less than one year.

(iv) It provides that the agreement shall not be subject to cancellation by either party, and that the loan shall not be repaid and the agreement shall not be terminated, rescinded or modified by mutual consent or otherwise if the effect thereof would be to make the agreement inconsistent with the conditions of this regulation or to reduce the adjusted working capital of the applicant or registrant below the amount required by this regulation;

(v) Sole possession and control of the subordinated assets must be maintained by the borrower for the term of the agreement;

(vi) It provides that no default in the payment of interest or in the performance of any covenant or condition by the registrant or applicant shall have the effect of accelerating the maturity of the indebtedness;

(vii) It provides that any notes or other written instruments evidencing the indebtedness shall bear on their face an appropriate legend stating that such notes or instruments are issued subject to the provisions of a subordination agreement which shall be adequately referred to and incorporated by reference;

(viii) It provides that any securities or other property loaned to the registrant or applicant pursuant to its provisions may be used and dealt with by the registrant or applicant as part of his capital and shall be subject to the risks of the business; and

(ix) Copies of each such agreement and of any notes or written instruments, evidencing the indebtedness are filed, within 10 days after each such agreement is entered into, with the regional office of the Commission for the region in which the registrant or applicant maintains his principal place of business, together with a statement of the full name and address of the lender or creditor and the business relationship of the lender or creditor to the registrant or applicant.

(6) The term "adjusted working capital" means working capital less:

(i) Five percent of all unsecured receivables used by the applicant or registrant in computing his working capital;

(ii) The amount by which any advances paid by the applicant or registrant on cash commodity contracts and used in computing his working capital, exceeds 90 percent of the market value of the commodities covered by such contracts;

(iii) In the case of cash commodity inventories that are hedged by bona fide hedging positions in the futures markets

(as defined in § 1.3(z) of these regulations), the amount by which the value of such inventories used by the applicant or registrant in computing his working capital, exceeds 95 percent of the market value of such inventories;

(iv) In the case of all inventories which are included as current assets and which are not hedged in futures markets, the amount by which the value of such inventories used by the applicant or registrant in computing his working capital exceeds 80 percent of the market value of such inventories; *Provided, however*, That with respect to those units of inventory that are committed to fixed price sales, there shall be no deduction from the value of such units of inventory used by the applicant or registrant in computing his working capital if the value so used does not exceed the committed sales price;

(v) The amount by which the value of securities and obligations used by the applicant or registrant in computing his working capital exceeds:

(A) In the case of preferred stocks, 80 percent of the market value thereof;

(B) In the case of common stocks, 70 percent of the market value thereof;

(C) In the case of commercial bonds and revenue bonds, 90 percent of the market value thereof;

(D) In the case of obligations of, or guaranteed by, the United States, and of general obligations of any State, or of any political subdivision thereof, 100 percent of the market value thereof;

(E) In the case of all other securities classifiable as current assets under this regulation, 70 percent of the market value thereof; and

(vi) That amount of subordinated borrowings and other forms of subordinated indebtedness which is in excess of 75 percent of the total of capital and subordinated liabilities.

(7) The term "aggregate indebtedness" means that portion of the total liabilities of an applicant or registrant which is not adequately collateralized, but excluding:

(i) Advances received by the applicant or registrant against bills of lading issued in connection with the shipment of commodities sold by the applicant or registrant;

(ii) Equities in partners' and officers' commodity futures accounts;

(iii) Equities in customers' commodity futures accounts segregated in accordance with the Act and regulations; and

(iv) The amount of indebtedness subordinated to the claims of all general creditors of the applicant or registrant pursuant to a satisfactory subordination agreement, as defined in this section.

(8) Liabilities shall be deemed to be "adequately collateralized" when, pursuant to a legally-enforceable written

instrument, such liabilities are secured by identified assets that are otherwise unencumbered and the market value of which exceeds the amount of such liabilities by 10 percent or more.

(9) The term "customer" shall include an "option customer" as defined in Part 32 of this chapter.

(d) In the case of open futures contracts held in customers' accounts carried by the applicant or registrant, the safety factor shall be one-half of one percent of the market value of the greater of either the total long or total short futures contracts in each commodity in all such accounts: *Provided, however*, (1) That such safety factor shall not apply to any spread or straddle held for the same account in the same commodity, on the same market, in the same crop year, and (2) that in the case of any intermarket or intercrop year spread or straddle, or any intermarket and intercrop year spread, held for the same account in the same commodity, the safety factor shall be one-fourth of one percent of the market value of that side of each such spread or straddle having the greater market value.

(e) In the case of open futures contracts held in proprietary accounts carried by the applicant or registrant, the safety factor shall be 10 percent of the market value of the greater of either the total long or total short futures contracts in each commodity in all such accounts: *Provided, however*, (1) That such safety factor shall not apply to any spread or straddle held for the same account in the same commodity, on the same market, in the same crop year, or to any contract representing a bona fide hedging transaction as defined in § 1.3 (z) (however, such factor shall apply to contracts specified in paragraph (4) of § 1.3(z), representing hedges against unfilled anticipated requirements); nor shall it apply to any contract resulting from a "changer trade" made in accordance with the rules of a contract market which have been submitted to and approved by the Commission, and (2) that in the case of any intermarket or intercrop year spread or straddle, or any intermarket and intercrop year spread or straddle, held for the same account in the same commodity, the safety factor shall be 5 percent of the market value of that side of each such spread or straddle having the greater market value.

[41 FR 3194, Jan. 21, 1976, as amended at 41 FR 51814, Nov. 24, 1976]

17 CFR § 10.3 (1977)

§ 10.3 Suspension, amendment, revocation and waiver of rules.

(a) These rules may, from time to time, be suspended, amended or revoked in whole or in part. Notice of such action will be published in the FEDERAL REGISTER.

(b) In the interest of expediting decision or to prevent undue hardship on any party or for other good cause the Commission may order the adoption of expedited procedures and may waive any rule in Subparts A through H of this part in a particular case and may order proceedings in accordance with its direction upon a determination that no party will be prejudiced and that the ends of justice will be served. Reasonable notice shall be given to all parties of any action taken pursuant to this provision.

(c) The Presiding Officer, to expedite decision or to prevent undue hardship on any party, may waive any rule in Subparts A through G of this part when neither party is prejudiced thereby. Reasonable notice shall be given to all parties of any action taken pursuant to this provision.

directs or authorizes the public disclosure of the investigation; (b) the information or documents are made a matter of public record during the course of an adjudicatory proceeding; or (c) disclosure is required by the Freedom of Information Act, 5 U.S.C. 552, and the rules adopted by the Commission thereunder, 17 CFR Part 145. Procedures by which persons submitting information to the Commission during the course of an investigation may specifically seek confidential treatment of information for purposes of Freedom of Information Act disclosure are set forth in 17 CFR 145.9. A request for confidential treatment of information for purposes of the Freedom of Information Act shall not, however, prevent disclosure for law enforcement purposes or when disclosure is otherwise found appropriate in the public interest and permitted by law.

17 CFR § 10.61 (1977)

§ 10.61 Time and place of hearing.

(a) *Notice.* All parties shall be notified of the time and place of hearing, which shall be fixed with due regard for the public interest and the convenience and necessity of the parties and their representatives.

(b) *Requests for change.* A request for postponement of a hearing or for a change in the place assigned for hearing will be granted by the Administrative Law Judge only for good cause shown.

17 CFR § 11.3 (1977)

§ 11.3 Confidentiality of investigations.

All information and documents obtained during the course of an investigation, whether or not obtained pursuant to subpoena, and all investigative proceedings shall be treated as non-public by the Commission and its staff except to the extent that (a) the Commission

COMMODITY FUTURES
TRADING COMMISSION

NEWS

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FEDERAL REGULATORY AGENCY
FOR FUTURES TRADING

Release #243-77

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For Release Monday, January 17, 1977

WASHINGTON -- John V. Rainbolt, II, Vice Chairman of the Commodity Futures Trading Commission, today announced that 49 firms were registered by the deadline of 12:01 a.m. today as futures commission merchants (FCM's) to sell foreign commodity options in the U. S. as required by CFTC regulations.

Rainbolt reminded consumers considering the purchase of commodity options that registration with the CFTC does not constitute a CFTC endorsement of the firm or an indication that the firm is reputable or legitimate. It means only that the firm has met certain minimum capital requirements and fitness checks have been negative.

Another 15 firms, Rainbolt said, made application of FCM's but did not meet the Commission's requirements for a variety of reasons, including late application, incomplete registration applications, or inadequate minimum working capital. As a result, they cannot legally sell commodity options.

He also announced that CFTC administrative proceedings have

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been initiated against three of the 15 firms: British American Commodity Options Corp., New York; First New York Commodity Options, Ltd., Englewood Cliffs, New Jersey; and London Commodity House, Inc., Chicago. These companies are charged with certain fraudulent or deceptive practices in the sale of commodity options and will not be registered pending an administrative hearing.

Three other of the 15 applicants were registered as FCM's to trade futures but not options, because they met the \$10,000 requirement for FCM's but apparently did not meet the \$50,000 minimum adjusted working capital requirement for commodity option trading, Rainbolt said.

Four companies were advised that their applications were received late, would be processed in the order received, but that they would not be registered today, and, thus, could not legally sell options until registered. Another firm, Monex Trading Corp., will be allowed to trade options for 30 days while not registered, pending further consideration by the CFTC as to possible confusion between the name of this subsidiary and its parent firm (Monex International, Ltd.).

The remaining four firms were not registered because of unresolved questions as to their financial status.

In response to questions concerning the recent court injunction against the CFTC's segregation regulation, Rainbolt said the Commission may have to review its entire approach to options trading. "The Commission may be forced to reconsider its acceptance of interim trading in domestic options pending the start of a pilot

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program for trading of commodity options on exchanges," he said.

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NOTE: The complete list of firms previously registered with the CFTC and known to be selling commodity options or recently applying as FCM's for trading in commodity options (as of January 17, 1977) is attached.

REGISTERED AS FUTURES COMMISSION MERCHANTS (FCM'S) TO
TRADE COMMODITY OPTIONS AS OF MONDAY, JANUARY 17, 1977

A. Companies previously registered as FCM's with the CFTC and
believed to be selling commodity options

1. ACLI International Commodity Services, Inc.
2. Brandeis Goldschmidt & Co., Inc.
3. Barclay Commodities
4. Clayton Brokerage Co. of St. Louis, Inc.
5. Conti-Commodity Services, Inc.
6. Carl Borchsenuis Co., Inc.
7. Christman Clearing Co.
8. Commodity International
9. Czarnikow-Rionda Co., Inc.
10. Cleary Trading Co., Inc.
11. Dishy Brothers
12. Drexel Burnham & Co., Inc.
13. First Commodity Corp. of Boston
14. First London Commodity Options
15. First Western Commodity Options
16. Heinold Commodities, Inc.
17. Herzog Commodities, Inc.
18. Intsel Commodities, Inc.
19. International Trading Group, Ltd.
20. International Commodities Corp.
21. Lamborn and Co., Inc.
22. Lincolnwood Commodities Inc. of California
23. Lind-Waldock & Company
24. Maduff and Sons
25. Madda Trading Company
26. Mocatta Trade Corporation
27. Murlas Brothers Commodities, Inc.
28. Primary Metal & Mineral Corp.
29. Palmer Trading Co., Inc.
30. Reynold Securities
31. Richardson Commodities, Inc.
32. Rosenthal & Company
33. Shearson Hayden Stone, Inc.
34. Siegel Trading Co., Inc.
35. Stotler & Company
36. R. G. Wilson Commodities, Inc.
37. Woodhouse Drake & Carey Inc.
38. Woodstock, Inc.

B. Companies registered on Friday, January 14, 1977, as FCM's to sell commodity options

1. A L & T Trading, Inc.
2. Chartered Systems Corp. of New York, Ltd.
3. Commodity Analysis, Inc.
4. Crown Colony Options, Ltd.
5. Economic Systems Commodities, Inc.
6. Federal Gold & Silver
7. First Dover Commodity Options Corp.
8. First New York Investors Corp.
9. International Precious Metals Corp.
10. London Commodity Options, Ltd.
11. Neuberger Securities Corp.

C. Companies registered on Friday, January 14, 1977, as FCM's to trade futures but not commodity options. These firms apparently did not meet the \$50,000 adjusted working capital requirement of the options regulations and, thus, can legally sell futures but not commodity options.

1. Precious Metals Associates, Inc.
2. Williston Corp.
3. Dillon-Gage, Inc.

D. Companies sent telegrams indicating that their applications were received late and they would be processed in the order received, but the companies will not be registered to trade today (January 17).

1. Bristol Options
2. Capitol Financial Services
3. International Commodity Options
4. Sierra Commodities Corp.
- *5. Monex Trading Corp.

E. Companies making application for FCM registration that were not registered.

a. Companies against whom CFTC has filed an administrative action.

1. British American Commodity Options Corp.
2. London Commodity House, Inc.
3. First New York Commodity Options, Ltd.

*Monex Trading Corp. will be allowed to trade options for 30 days while not registered, pending further consideration by the CFTC as to possible confusion between the name of this subsidiary and its parent firm (Monex International, Ltd.).

b. Companies whose registration application has not been approved for other reasons.

4. Options Trading Corp.
5. Commonwealth Commodities
6. Royce Brokerage of Dallas, Inc.
7. Imperial Options

IN RE PETRO

U. S. Dept. of Agriculture, May 12, 1953

PACA Docket No. 6928

§b.6 Extension of license pending renewal or issuance proceedings.

Even though, under Department of Agriculture regulations, an application of a licensed produce dealer for a license under a different trade name is an application for a new license and not for renewal of an existing license, the applicant's existing license continues in effect until his application for a new license has been finally determined, by virtue of Section 9 (b) of the Administrative Procedure Act.

§b.2 Opportunity for hearing.

The Perishable Agricultural Commodities Act requires that a party be given opportunity for hearing before his application for license is refused. Where an application is returned without opportunity for hearing, the refusal is contrary to statutory requirements, and the applicant should not be denied a subsequent license because of violations resulting from this unauthorized action of the licensing authorities.

THOMAS R. FLAVIN, *Judicial Officer*. In this proceeding under the Perishable Agricultural Commodities Act, 1930, as amended (7 U. S. C. 499a et seq.), an order was issued July 12, 1957 (16 A. D. 705), denying respondent's applications of December 7, 1956, for a license under the act as a commission merchant, dealer or broker to engage in the business of handling fresh and frozen fruits and vegetables in interstate and foreign commerce. On July 26, 1957, respondent filed a petition for reconsideration of the order of July 12, 1957, and complainant filed an answer to the petition August 20, 1957. Respondent filed a reply to complainant's answer August 28, 1957.

Respondent's application for a license was denied in the order of July 12, 1957, primarily due to his engaging in business knowingly as a commission merchant, dealer or broker without a valid license in many transactions over an extended period of time beginning July 7, 1955. A license, No. 152903, had been issued to respondent, trading as Sam Petro Tomato Company, for the period of one year effective July 6, 1954. On July 5, 1955, respondent submitted an application for a license and the required license fee to a representative of complainant at Houston, Texas.

In his petition for reconsideration respondent contended for the first time in this proceeding that the application of July 5, 1955, was for renewal of an existing license and that, pursuant to the operation of section 9 (b) of the Administrative Procedure Act (5 U. S. C. § 1002 (b)), such license continued in effect and could not be revoked or annulled by the refunding of the license fee to him. While there was some reference in the record to the application of July 5, 1955, the evidence therein was insufficient to determine the nature of such application, the facts surrounding its filing and the legal consequences thereof. By order dated September 4, 1957 (16 A. D. 901), the proceeding was remanded to the hearing examiner with instructions to reopen the hearing for the purpose of obtaining additional evidence with respect to the application of July 5, 1955. A reopened hearing was held November 13, 1957, at Houston, Texas. After the reopened hearing, the parties filed briefs and the matter is before us on the basis of the reopened record.

The evidence adduced at the reopened hearing shows that respondent's application of July 5, 1955, was treated as an application for a new license since respondent applied for a license in the name of Petro Product Service whereas the existing license was in the name of Sam Petro Tomato Company. Section 46.13 of the regulations issued under the act (7 C. F. R. 46.13) provides that "...In case the business is conducted in a name different from that shown on the license, a new license is required." Therefore, under the regulations, the application of July 5, 1955, was an application for a new license and did not require automatic renewal of an existing license.

It appears, however, as contended by respondent, that respondent's then existing license, that is, license No. 152903, continued in effect after July 6, 1955, until his application for a new license had been finally determined by the Department, pursuant to section 9 (b) of the Administrative Procedure Act (5 U. S. C. § 1008 (b)) which provides that "...In any case in which the licensee has, in accordance with agency rules, made timely and sufficient application for a renewal or a *new license*, no license with reference to any activity of a continuing nature shall expire until such application shall have been finally determined by the agency." (Italics supplied.) Cf. *Pan-Atlantic Steamship Corp. v. Atlantic Coast Line Railroad Co.*, 353 U. S. 436 (1957). See S. Rep. No. 752, 79th Cong., 2d Sess. 25 (1945); N. R. Rep. No. 1950, 79th Cong., 2d Sess. 40 (1945); 92 Cong. Rec. 2153, 5654 (1946). See also Attorney General's Manual on the Administrative Procedure Act, pp. 91-92 (1947).

[9b.6] "Section 9 (b) of the Administrative Procedure Act is a direction to the various agencies. By its terms there must be a license outstanding; it must cover activities of a continuing nature; there must have been filed a timely and sufficient application to continue the existing operation; and the application for the new or extended license must not have been finally determined." *Pan-Atlantic Steamship Corp. v. Atlantic Coast Line Railroad Co.*, *supra* at 439. By his application of July 5, 1955, respondent was attempting to continue a long-existing business as a produce dealer and, consequently, license No. 152903 remained in force and effect by operation of law until final action was taken upon the application of July 5, 1955.

[5b.2] Section 4 (d) of the Perishable Agricultural Commodities Act, 1930, as amended (7 U. S. C. § 499d (d)), requires that if after investigation the Secretary believes that an applicant for a license should be refused such a license, the applicant "shall be given an opportunity for hearing within sixty days from the date of the application to show cause why the license should not be refused." Respondent's application for a license was received by a complainant's representative at Houston, Texas, July 5, 1955, and at Washington, D. C., July 12, 1955, and instead of affording respondent an opportunity for hearing within sixty days from either date, complainant, by a letter dated August 3, 1955, returned this application to respondent and informed him that a second application could be filed. Complainant stated in such letter that he felt justified in questioning the fitness of respondent to obtain a license pursuant to section 4 (d) of the act. However, no formal complaint was then filed and respondent was not given an opportunity for hearing within the statutory period on such application, that is, the application of July 5, 1955. Complainant's action was not authorized by the act or the regulations issued thereunder and was contrary to statutory requirements. *In re LaRosa Tomato Distributors, Inc.*, 16 A. D. 449 (1957); *Anonymous Decision*, 4 A. D. 127 (1942). See also section 3 (a) of the Administrative Procedure Act (5 U. S. C. § 1002 (a)).

In our order of July 12, 1957, it was found that respondent had, in at least 60 separate transactions during the approximate period July 6, 1955, through January 27, 1956, engaged in the business of handling fresh and frozen fruits and vegetables in interstate and foreign commerce without a valid and effective license under the act and this finding was the primary reason for denying respondent's application for a license. On the basis of the reopened record, however, it is apparent that respondent had a license, No. 152903, pursuant to section 9 (b) of the Administrative Procedure Act at least until August 3, 1955, when his application to do business as Petro Produce Service was returned to him, on August 6, 1955, allowing three days for the letter of August 3, 1955, to reach respondent at Houston, Texas. Several of the transactions referred to in the order of July 12, 1957, occurred during the period July 7 through August 6, 1955. In addition, the procedure adopted by complainant in returning respondent's application was unauthorized and contrary to statutory requirements. If such requirements had been followed, respondent would have clearly been licensed by virtue of section 9 (b) of the Administrative Procedure Act during most if not all of the period July 7, 1955, through January 27, 1956, pending the outcome of a proceeding under section 4 (d) of the act. It might be argued, and complainant so contends, that even though respondent's application of July 5, 1955, may have been invalidly denied and returned to him, respondent operated without a license as a result thereof in violation of section 3 (a) of the act (7 U. S. C. § 499c (a)). Even if we assumed this to be the case,¹ respondent should not now be denied a license due to violations resulting, in part, from the unauthorized actions of the licensing authorities.

In view of the foregoing, the order of July 12, 1957, is hereby vacated and the license applied for by respondent shall be issued.²

¹ But see section 3 (a) of the Administrative Procedure Act (5 U. S. C. § 1002 (a)).

² The Dash and Kenworthy transactions set forth in Findings of Fact² and 3, respectively, of the order of July 12, 1957, are insufficient to alter this conclusion. Therefore, it is unnecessary to consider respondent's motion to receive certain documents in evidence herein with respect to such transactions.

**COMMODITY FUTURES TRADING
COMMISSION
STANDARDS FOR DENIAL OF
REGISTRATION**

Release of interpretation

The Commodity Futures Trading Commission (the "Commission") has announced that it is releasing its interpretation of certain standards found in the Commodity Exchange Act (the "Act") concerning denial of registration of futures commission merchants, associated persons, commodity trading advisors, commodity pool operators and floor brokers. The Commission has determined that this interpretation of general applicability which has been formulated and adopted by the Commission should be made public to assist prospective applicants for registration and to permit members of the public to comment on the standard which the Commission feels are appropriate in determining whether a person is suited to engage in the business for which he is applying for registration.

Section 8a of the Act states in part that:

Sec. 8a. The Commission is authorized—

(1) to register futures commission merchants and persons associated therewith as described in section 4k of this Act, commodity trading advisors, commodity pool operators, and floor brokers upon application in accordance with rules and regulations and in form and manner to be prescribed by the Commission; and

(2) to refuse to register any person —

(A) if the prior registration of such person has been suspended (and the period of such suspension shall not have expired) or has been revoked;

(B) if it is found, after opportunity for hearing, that the applicant is unfit to engage in the business for which the application for registration is made, (i) because such applicant, or, if the applicant is a partnership, any general partner, or, if the applicant is a corporation, any officer or holder of more than 10 per centum of the stock, at any time engaged in any practice of the character prohibited by this Act or was convicted of a felony in any State or Federal court, or was debarred by any agency of the United States from contracting with the United States, or the applicant willfully made any material false or misleading statement in his application or willfully omitted to state any material fact in connection with the application, or (ii) for other good cause shown; or

(C) in the case of an applicant for registration as futures commission merchant, if it is found after opportunity for hearing, that the applicant has not established that he meets the minimum financial requirements under section 4f of this Act; . . .

Certain provisions of section 8a(2) are self-explanatory. For example, where an applicant has been suspended and the

period of such suspension has not expired or where the applicant's prior registration has been revoked, the Commission is authorized to deny registration. In addition, where an applicant willfully made a materially false and misleading statement in his application or willfully omitted to state any material fact in connection with the application, the Commission is authorized to deny registration, if, after opportunity for hearing, it is determined that because of such action the applicant is unfit to engage in the business. However, other provisions in section 8a(2) are not so specific, such as the authority after opportunity for hearing to deny registration for having engaged in a practice of the character prohibited by the Act. In addition, the Commission is authorized, after opportunity for hearing, to deny registration if "for other good cause shown", the applicant is unfit to engage in the business for which he has made application for registration. These criteria are not specific and need Commission interpretation. The Commission has interpreted "for other good cause shown" to include the following:

1. The Commission may refuse to register a person as a futures commission merchant, floor broker, associated person, commodity trading advisor, or commodity pool operator, if

A. The operations of such person disrupt or would tend to disrupt orderly market conditions, or cause or would tend to cause sudden or unreasonable fluctuations or unwarranted changes in the prices of commodities;

B. Such person, or any partner, officer, director, person performing similar functions, controlling person, or holder of more than 10 per centum of the stock thereof—

(i) Has been convicted within ten years preceding the filing of the application of any felony or misdemeanor which (1) involves any transactions or advice concerning any commodity or security; (2) arises out of conduct of the business of a futures commission merchant, floor broker, associated person, commodity trading advisor, commodity pool operator, securities broker, securities dealer, investment advisor, or an affiliated person or employee of any of the foregoing; (3) involves embezzlement, fraudulent conversion, misappropriation of funds or securities, counterfeiting, gambling, or similar crimes; or (4) involves the violation of section 1341, 1342, 1343 of Title 18, United States Code; or

(ii) At the time of the application, is permanently or temporarily enjoined by order, judgment or decree of any court of competent jurisdiction, or by agreement or settlement to which the Commission or the Securities and Exchange Commission is a party from acting as a commodity trading advisor, commodity pool operator, futures commission merchant, floor broker, associated person, securities broker, securities dealer, investment advisor, or as an affiliated person or employee of any of the foregoing, or from engaging in or continuing any con-

duct or practice in connection with any such activity or involving any transaction or advice concerning commodities or securities; or

(iii) Within ten years preceding the filing of the application, has been found (1) to have willfully violated any provision of the Commodity Exchange Act, the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, or any rule or regulation under any such statutes; (2) to have willfully aided, abetted, counseled, commanded, induced, or procured the violation by any other person of such statutes or rules or regulations thereunder; or (3) to have failed reasonably to supervise, with a view to preventing violations of such statutes, rules or regulations, another person who commits such a violation, if such person is subject to his supervision. For the purposes of this clause (3) no person shall be deemed to have failed reasonably to supervise any person, if—

a. There have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person, and

b. Such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with.

2. The Commission may refuse to register a person as a futures commission merchant, floor broker, or associated person if such person or any partner, officer, director, person performing a similar function, any controlling person or any holder of more than 10 per centum of the stock thereof is subject to an outstanding order of the Commission denying trading privileges on any contract market to such person, or suspending or revoking the registration of such person as a commodity trading advisor, commodity pool operator, futures commission merchant, floor broker, or associated person, or suspending or expelling such person from membership on any contract market.

This interpretation regarding "for other good cause shown" is not exclusive; i.e., there may be other instances for which the Commission, after opportunity for hearing, may determine to deny registration, such as where an applicant has been convicted of certain crimes of moral turpitude or where a quasi-governmental body has found that an applicant has committed material violations of its rules. On the other hand, in some instances the Commission may determine that a person is fit for registration even though that person has committed an act listed in this interpretation. However, the Commission feels that its interpretation of "for other good cause shown" is as specific as the Commission can be at this time. It should be noted that the crimes specified in the Commission's interpretation are the types of crimes that the Commission believes are appropriate grounds for refusal to register under sec-

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tion 8a(2)(B)(i) of the Act. It should also be noted that although this interpretation was prepared for purposes of denial of registration, the Commission believes that it is also appropriate for purposes of suspension or revocation of registration. Members of the public should feel free to comment on the Commission's interpretation of section 8a(2), and, in particular, the "for other good cause shown" criteria found in section 8a(2)(B)(ii). Comments should be sent to the Commodity Futures Trading Commission, 1120 Connecticut Avenue, NW, Washington, D.C. 20036.

Issued: June 30, 1975.

WILLIAM T. BAGLEY,
*Chairman, Commodity Futures
Trading Commission.*

[FR Doc.75-17363 Filed 7-2-75;8:45 am]